E/CONF.39/H/56
1 Nov.1962
ORIGINAL : ENGLISH

UNITED NATIONS CONFERENCE
ON THE APPLICATION OF SCIENCE AND TECHNOLOGY
FOR THE BENEFIT OF THE LESS DEVELOPED AREAS

Agenda Item : H.3

United States of America

DEVELOPMENT BANKS

By Vincent CHECCHI,
President, Checchi and Company,
Washington, D.C.

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No. 735
H.3

DEVELOPMENT BANKS

Vincent Checchi, President[1]
Checchi and Company, Washington, D. C.

Introduction

1. The purpose of this paper is to examine the circumstances in which development banks are created, their potential as an instrument for accelerating economic change, and the factors affecting success in utilizing this potential. As used in this paper, development banks are autonomous financing institutions organized in developing countries with assistance from foreign lending agencies for the purpose of lending to or otherwise investing in economically desirable projects in the private sector.

2. The number of such institutions has increased steadily in the past several years, encouraged by financial and technical assistance from U. S. Government and international lending agencies. As of June 30, 1962, the World Bank and its affiliates, the Inter-American Development Bank, the U. S. Export-Import Bank and the U. S. Agency for International Development had made 105 loans to 50 development banks in the less developed nations totaling $738 million. Of the 50 banks, some 20 were created with the technical advice of international agencies or as a direct result of loans from these agencies. Private American and other banking firms have also invested in development banks.

3. Development banks provide attractive features to an international lending agency. They constitute "projects" and can thus receive loans which the lending agency is happy to make. Such loans are relatively safe in the sense that they are reloaned or "retailed" by the development bank to a number of projects, diversifying the risk. In addition, the lending agency bears no risk on the individual projects. The development bank is obliged to repay the whole amount of the loan made by the lending agency regardless of what happens to individual projects. Through the development bank channel, the international lending agency is relieved of the task of finding sound projects in the private sector.

4. The development bank, as an autonomous financial institution, is more amenable than government agencies to technical advice from the lending agency and to the selection of competent professional management. Development banks, with sufficient independence, broad enough powers, and imaginative enough management, could serve as a powerful financial force for encouraging economic change and new attitudes toward business. Each bank in each country provides a mechanism for focusing attention on opportunities to encourage private local and foreign investment in the bank itself and in projects financed by the bank.

1/ Mr. Checchi has directed a number of studies on this subject

5. Development banks thus represent an institutional arrangement ideally suited to the policies and operational procedures of foreign sources of financing. They are in a good position to receive foreign assistance which is convenient for both the lending and the borrowing country.

6. As an additional and sometimes the sole source of medium- and long-term credit for industrial enterprise, development banks can be a powerful stimulant for new investment and for new jobs. In fact, the very process of creating such an institution stimulates new projects and creates a favorable climate for risk-taking.

7. Adequately conceived and operated, they can help create a vigorous class of local entrepreneurs and investors. They can help gather and channel local savings. They can serve as a training ground for professional personnel such as economists, accountants, and engineers as well as for private entrepreneurs and managers. They can influence public attitudes toward business and can have an important effect on business organization, law, and the related apparatus of conducting business. They can become self-supporting institutions performing functions so important in the economy that they become points of stability in the society because their valuable work must continue despite changes in government.

8. This paper will cover some of the varied considerations relating to development banks: the need for them, their form, their scope, their relation to other institutions, and some special problems which they face and which they generate.

The Need

9. A development bank or a similar development institution is essentially a device to fill a gap in the existing financial structure of a country. (The inducements offered by the Government to encourage the creation of small business investment companies in the United States was an effort to fill what was considered to be a gap in the credit system of that country.) Most development banks which now exist were designed to meet a need for medium and long-term credit on reasonable terms for new industrial enterprises. However, some of them have made few loans, not because of a lack of funds but because of shortcomings such as inadequate management simply failing to carry out the function of the bank or a lack of applications sufficiently well prepared to justify a loan. The problem of need therefore is usually broader than the problem of adequate credit availability.

10. Even a cursory examination of the experience of development banks and of U. S. Government and other international loans to these banks suggests that there is more money available for industrial development than there are projects in satisfactory condition to qualify for loans under normal banking criteria.

11. The shortage of projects is, in part, a result of the shortage of skills needed in preparing projects for financing. This problem can be met by providing, through a development bank or through a separate institution, technical services to help potential borrowers identify, investigate, and organize specific projects for financing.

12. But in many of the smaller developing countries, the shortage of projects is even more a result of a shortage of entrepreneurs -- of individuals and groups willing and able to spend their time, effort and money to identify and develop projects. In these areas, the need is perhaps for institutions which help create a market for development banks and related institutions.

13. There thus appear to be needs for several kinds of development banks --

broadly defined. One kind consists of those sponsored by the World Bank and other official lending agencies in countries where entrepreneurs and investors exist in sufficient numbers and kind to respond actively when financing and technical assistance are made available on reasonable terms.

14. A second group would include an institution fitting a situation where there are few entrepreneurs, where the market is small, and where there is not likely to be any significant short-term response to increased credit availability. This kind of institution is perhaps more nearly an investment company than a lending institution, fills the function of the entrepreneur and acts as the "self-starter." Such institutions would tend to rely heavily on government for initial capital, would at first seek to attract local investors in enterprises initiated by the institution alone or in association with foreign groups, and eventually would attract local initiators of new enterprises.

15. The diagnosis of the problem is as important in prescribing financial institutions as in medicine. While every economy probably has entrepreneurs, the problem is one of accurately gauging the nature and extent of entrepreneurial potential. It is a questionable use of resources to create a development bank to make loans where the effective demand for credit does not exist. Where the absence of entrepreneurs is a problem, a source of credit alone or even in conjunction with technical assistance is not the solution.

16. All development banks to a greater or lesser degree attempt to undertake some entrepreneurial or promotional functions. By and large, however, development banks by circumstances or by choice are operated as lending agencies. When they take equity, they do so usually to maximize profit, rather than because such action is necessary to spark the creation of the particular enterprise.

17. Some development banks will tend to become increasingly conservative as time goes on. The responsibility of management to avoid losses will soon outweigh its responsibilities to pioneer. Once the institution is created, needs will change. The financial structure is an evolving one and circumstance may require other financial institutions to fulfill other needs, such as insurance companies, savings and loan associations, and housing banks. There is even the happy prospect that the development banks can help create specialized institutions to fill the need for specialized kinds of financing. The development bank may thus work itself out of a job.

18. There are other needs bearing on a development bank--its potential role in creating an organized securities market, its role in linking local and foreign investment in projects, and others. The needs must be determined with care because the institution--whether conventional development bank, investment corporation or other--must be carefully designed to meet that need.

The Form

19. There can be no such thing as the standard model, ready-made, all-purpose development bank which can be utilized effectively in any country. The needs vary country by country and the form must be tailored to each situation. Should the development bank be government-owned, privately-owned, or have a mixed ownership? Whatever the ownership, experience suggests that the institution must have independence of decision if it is to grow and to command respect and resources in the money markets at home and abroad.

20. Private organizations are likely to have greater flexibility and may result in more stable institutions in the long run, since the management of the private bank will be more insulated from political pressures and political

changes than is possible in a government-owned and controlled institution. Where government can appropriately mobilize private resources and energies to take over the job, it is certainly to its advantage to do so.

21. There are situations in which the government must assume this burden either because of the lack of a local entrepreneurial or investor class, or because there is need for a pace-setter to enter into projects which are either too large, too risky, or too oriented towards a particular government objective but nonetheless important for speeding the pace of industrial development.

22. In many countries the ideal set of development financing institutions might include both a government-owned and a privately-owned development bank which can complement each other's activities. Other circumstances favor the mixed institution in which the government participates financially, but which is controlled by private ownership. There are distinct advantages in early government financial support which may be necessary to the viability of the institution and which may provide some restraint on private management to protect the institution from becoming a tool of special private financial interests.

23. In some countries, this problem demands a form of organization which reflects some of the features of a privately-owned public utility.

24. The form of the bank must often take into account important local political or regional considerations. For example, the interests of the Greek and Turkish communities in Cyprus must be satisfactorily represented in any board of directors of a development bank in that country. Similarly, the sierra and costa areas of Ecuador are likely to demand specific acknowledgment by a development bank of their interests.

Relations with Other Institutions

25. One of the most important initial tasks for a new development bank will be to establish satisfactory relations with other important agencies with which it must work. The bank must be responsive to a number of masters, some within the country and some outside.

26. Perhaps the simplest of the bank's relations are those with the international assistance agencies. These agencies will expect the bank to be aggressive in utilizing the funds committed to it, but at the same time will expect the bank to follow sound financing practices to protect the funds with which it has been entrusted. Beyond these fairly obvious points, the bank will be expected to keep the agencies adequately informed on changes in scope of operations and to discuss any additional indebtedness which the bank may decide to undertake beyond the loans it has already received. The development bank must also begin the process of building relations with foreign private capital sources which may become the major source of the bank's foreign borrowings.

27. Domestically, the bank will have to work closely with the country's planning groups, the local technical assistance agency, local business organizations, and local banks and others in the local business and financial community. All of these organizations could be of valuable assistance to the bank's management in establishing policies and in evaluating applications for financing.

Scope

28. The local needs determine the scope as well as the form of the development bank. There is a wide range of possible functions which a development bank

can undertake.

29. Even in small economies, it may be desirable to have separate organizations for agricultural financing and for industrial financing. These require entirely different types of management attitudes and abilities and involve different administrative problems. In some instances where a development bank has been authorised to carry out both types of activities, it has frequently had to concentrate so extensively on needed agricultural financing that it failed to achieve any significant record in the industrial financing field.

30. In addition to lending and other financial services, development banks can provide technical assistance services, entrepreneurial services, and financial agency services.

31. Technical assistance services can be particularly important and include research and consulting functions covering the identification of business possibilities, assistance in developing the facts relating to technical and financial feasibility of projects, and technical and managerial advice to borrowers. The entrepreneurial services which a bank might provide involve the promotion, organization, and possibly direct management of enterprise. The agency services of a bank are such activities as trusteeships, investment management, placement of insurance and bonding, and acting as loan administrator for other organizations.

32. In one situation the primary need may be for a bank simply to administer loans. Elsewhere the need may be to provide its technical assistance services linked to credit to make the credit effective. In another situation, the entrepreneurial services of the bank linked to credit may be of vital importance.

33. The bank will probably begin by obtaining loans from the foreign assistance agencies. As the bank grows its record of performance may warrant its successful entry into the private capital markets of the world. At home the bank may borrow from the general public by placing its bonds and also in some instances by accepting demand or time deposits. The bank, however, may also do its borrowing from domestic institutions with whom it may negotiate loans, place its bonds, lay off loan participations or rediscount its portfolio.

34. A bank's discretion in borrowing from foreign lending agencies is rather limited in that all of the agencies maintain debt-equity ratio standards within a fairly narrow range. The bank must consider to what extent its entry into the domestic capital market to raise its own capital may divert local capital which might otherwise flow into equity financing of the projects to which the bank hopes to extend loan assistance.

35. A bank's loans may be in several fields and in a variety of forms. For instance, the bank can make medium- and long-term secured and unsecured loans to projects and business enterprises. The bank might make loans or extend guarantees to other financial institutions. The skill of the bank's management determines the degree to which the bank becomes successful in achieving its potential as a development institution. Conventional commercial banking standards may be too restrictive for developmental lending purposes. A loan commitment by a development bank may make it possible for the applicant to attract additional risk capital to the project.

36. A bank might invest directly in shares of stock either in existing or in new enterprises or it might buy shares by exercising conversion rights on its loans. The bank also could sell new issues of existing or new enterprises,

perhaps as part of an underwriting arrangement; the bank could spin off older securities; the bank might sell its own stock in order to acquire and expand its investment resources and its borrowing capacity. These buying and selling activities are part of the way in which the bank can stimulate a securities market in an economy where none has existed heretofore. Through these activities the bank can supplement equity capital required by an individual entrepreneur which might not otherwise be available to him; acquire it; hold new issues for seasoning and then place them on the market when they are salable. It can increase the supply of securities and thus broaden the market which might otherwise be dominated by a few investment groups; and it can educate the general public on the purchase of equity instruments and the taking of risks. Equally important, a well managed bank which exercises appropriate control on the enterprises it finances to protect the interests of minority stockholders will generate the kind of public confidence in equity securities which might otherwise be impossible to achieve.

37. By providing its guarantee for foreign borrowing by other enterprises, the bank can also act as a mobilizer of foreign credit substantially in excess of its own borrowed funds. Most foreign lending institutions find it difficult to administer international loans directly from abroad and require a local institution to assume the risk and sometimes the administration of such credit. This requirement of a local bank guarantor is even more indispensable in the case of foreign suppliers of capital goods who extend credit directly. Where domestic borrowers find it difficult to obtain such guarantees in adequate volume from local banking institutions, the development bank fulfills a vital need.

Special Problems

38. A most difficult problem facing development banks in many countries is the viability of the bank in its early years of operation. Normally, a bank requires a number of years of loss operations before it can reach a breakeven point. Aside from its lending operations, the bank is usually pioneering in introducing new forms of financial operations in the country and cannot expect to look forward to substantial non-interest income for some years after it commences operations. The bank's early income is tied to its lending volume. But at the same time, most banks are faced with a heavy initial investment in operating personnel and thus high operating costs relative to lending volume.

39. From its inception a bank can try to alleviate partially this problem by seeking a maximum of borrowed funds in relation to its capital to make up the total resources it needs to supply its market. However, the bank's international creditors, by the conditions they impose on their loans to the bank, fix the bank's maximum possible income from capital lending activities by applying standards of debt-equity ratio and interest spread (the amount the lending agency charges the bank and the amount of additional interest the lending agency permits the bank to charge its customers).

40. Some of the foreign assistance agencies have recognized this problem as have many governments of the countries in which such banks are established. They have provided various forms of subsidies to enable a development bank to weather the difficult early years and establish itself as a generator of capital and an energizing force for a growing economy.

41. Foreign assistance has served to subsidize the cost of management and technical personnel by paying the costs of technical assistance contracts providing foreign personnel for the bank's operations. United States Government

agencies have also been of substantial assistance in some cases by making such banks agents for the lending of aid-generated local currency funds (with consent of local government). By so doing, they have enabled the development bank to increase the volume of resources which it can lend with the same equity capital base at commissions which are higher than the interest spread on borrowed funds and with no risk to the bank. Local governments have also supported the operations of their development banks (in addition to concurring in the bank's being a lending agent for aid-generated local currency funds) by subsidizing operating costs and in some instances through local logistical support; by giving the bank additional agency business; by providing the bank with additional capital funds in the form of long-term low-interest loans or the purchase of preferred stock; by guaranteeing dividend payments by the bank to the bank's investors; and by providing the bank and its investors with tax exemptions.

42. A second major problem area which faces the international lending agencies which sponsor development banks involves the dangers of monopoly. The development bank is likely to be the sole practical source of credit, medium- and long-term, that is, other than short-term. It may also be the only channel through which equity capital can be raised from the general public.

43. The danger inherent in a single development bank is that it may fall under the control of a special interest group. In addition, its management, free from any of the influences of competition in a country, may acquire that kind of arrogance which makes it impossible for it to recognize a mistake. Such an institution, controlling as it does vast economic power relative to the economy in which it operates, might (due to ill-considered policies or mismanagement) come to be a deterrent rather than an accelerator of economic progress in its country. An over-emphasis on the part of such a bank on over-directing private enterprise rather than to support, stimulate and serve it would fall short of the purposes for which such banks are intended.

44. A third, and perhaps the most important problem is the shortage of skill and experience in the field of development lending. Unfortunately, we have yet to develop a direct means of measuring the effectiveness of a development bank's management in terms of its success as a "developer" rather than as an income earner. Lacking such a means, banks tend to be judged on their financial records and balance sheets, but this is at best an imperfect basis. Thus, there is every pressure on a bank's management to seek maximum profitability as its goal, rather than maximum development. Such a management is likely, for instance, to make equity investments only in situations where it desires to maximize profit for the bank, rather than in situations where its equity would permit a project to come into being. Such managements are not likely to welcome competition from other financial agencies and are more likely to short-circuit the growth of other needed financial institutions, such as investment banks, stock exchanges, savings banks, insurance companies, finance companies, and others.

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